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September 9, 2002

Via Hand Delivery

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20554

Re: In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, CC Docket No. 01-338;

Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98;

Deployment of Wireline Services Offering Advanced Telecommunications Capability, CC Docket No. 98-147; and

In the Matter of Petition of WorldCom, et al., Pursuant to Section 252 (e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration, CC Docket No. 00-218, 00-249 and 00-251.

Dear Ms. Dortch:

Attached please find a letter addressed to the Honorable Michael Powell, Chairman of the Federal Communications Commission, from William Daley, President of SBC Communications, Inc. The letter was delivered late yesterday afternoon, with copies to Commissioners Abernathy, Copps and Martin, as well as William Maher, Chief of the Wireline Competition Bureau.

We are submitting the original and one copy of this Memorandum to the Secretary in accordance with Section 1.12 of the Commission's rules. Please include a copy of this submission in the record of the above-listed proceedings. If you have any questions, please contact me at (202) 326-8895.

Sincerely,

Jim Lamoureux

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List ABCDE

Attachment

cc: J. Miller
T. Navin
R. Tanner

William M. Daley
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September 4, 2002

The Honorable Michael K. Powell
Chairman
Federal Communications Commission
445 12th Street, SW, 8th Floor
Washington, DC 20554

Dear Chairman Powell:

When the Commission established the TELRIC pricing methodology in its 1996 *Local Competition Order*, the Commission promised that in "the aftermath of the arbitrations and relying on the state experience," it would "issue additional guidance as necessary" on its TELRIC pricing methodology. *Local Competition Order* ¶ 620. Additional guidance in certain areas is now urgently needed. The Wireline Competition Bureau will have a first hand opportunity to apply the Commission's TELRIC methodology in setting prices in the Virginia arbitration proceeding. The Virginia arbitration thus provides the Commission an apt vehicle by which to assume its leadership role and to clarify the proper application of TELRIC. It is critical that the Commission take advantage of that opportunity.

The telecommunications industry, as you have recognized, "is riding on very stormy seas." A half million people have lost their jobs, and nearly two trillion dollars in market value has been lost in just the last two years. Dozens of carriers have filed for bankruptcy, and more bankruptcies loom as the industry staggers under the weight of declining revenues and, by some estimates, a trillion dollars in debt. The dire straits in which the industry finds itself have affected every segment. The long distance industry is down 68 percent year-to-date, the wireless industry is down 71 percent, and ILECs are down 40 percent. No one has been spared.

There are many reasons for this crisis, and no one silver bullet will end it, but, as you recognized in your recent testimony before the Senate Commerce Committee, "the long term prospects of the industry will not be bright if State and Federal policymakers do not continue to work hard and diligently to create genuine and viable economic and regulatory foundations for communications growth and competition." To that end, as you further noted, the Commission must assume a leadership role in creating "an efficient wholesale market."

An efficient wholesale market requires, *inter alia*, efficient wholesale pricing. Markets themselves best drive efficient pricing, but unless and until the Commission allows markets to set wholesale prices, it must strive to ensure that the regulatory methodology for setting wholesale prices is economically rational and creates the right incentives for incumbents and new entrants alike. Simply put, there is no chance of restoring health and sustainable competition in the telecommunications industry if wholesale prices promote inefficient entry, create artificial incentives to lease rather than build, and fail to cover the costs incumbents incur in furnishing network elements to new entrants.

Unfortunately, wholesale prices that are being set today suffer from all of these flaws. Dozens of carriers have been lured into local markets with artificially low wholesale rates that result from the misapplication of the Commission's TELRIC methodology. The California Public Service Commission, for example, recently discounted UNE-P rates to such an extent that UBS Warburg reports that AT&T will be able to obtain a 60% margin on local service using the UNE-P. Other states likewise have lowered their UNE-P rates to stimulate UNE-P usage and create the appearance of "competition." These reductions do not promote efficient entry; they simply gin up incumbent access line losses to firms that bring nothing to the table but a marketing and billing organization. At the same time, they discourage other, potentially more efficient, carriers, including those that would compete with their own facilities, from entering the market by making it more difficult for such carriers to obtain the market share they need to survive.

These artificially low rates also deny SBC and other ILECs the opportunity to recover their costs when they provide UNEs. When a CLEC uses the UNE-P, the incumbent LEC retains virtually all of the costs associated with retail service. In fact, in some respects, the incumbent's costs *increase* because of costs associated with wholesale obligations. Yet the incumbent loses roughly 60% of the revenues that were available at retail. As SalomonSmithBarney more bluntly put it: "They get half the revenue with the same cost." The result, as Commerce Capital Markets Equity Research (and other analysts) have noted, is that current UNE prices are "at a deep discount to Regional Bell's costs[.]" Obviously, a wholesale regime in which the wholesaler loses money with every sale is not just and reasonable or sustainable.

As you know, SBC believes that much of the problem lies with TELRIC itself. My purpose in this letter, however, is not to take issue with TELRIC. I sincerely hope that the Commission will take a hard look at TELRIC, but that is an issue for another day. So long as TELRIC remains the law of the land, it is imperative that this methodology be properly, fairly, and consistently applied. That is not happening.

As with any mathematical model, the validity of the outputs in a UNE pricing model depends on the validity of the inputs. But some of the key inputs that are being used in state cost proceedings are at odds with market realities and inconsistent with the core assumptions inherent in TELRIC itself. In some cases, states make no attempt even to determine the correct input. Instead, they choose inputs that will achieve a pre-

determined end-result: a TELRIC rate that will give AT&T the 45% margin it demands before it will enter local markets using the UNE-P. In other cases, lacking necessary guidance from the Commission, states simply mis-apply TELRIC.

By providing clear guidance with respect to these inputs, the Commission would in no way be limiting the proper exercise of discretion by the states in setting TELRIC rates. States would remain free to take into account state and regional variations in determining appropriate inputs. That is at it should be. But they would be given clear guidance with respect to certain core principles and assumptions that do not vary from state to state. That too is as it should be. Uniform interpretation and application of such principles and assumptions is necessary to avoid an incoherent and *ad hoc* national UNE pricing regime. Guidance with respect to these principles and assumptions is thus critical to ensuring proper and consistent application of the Commission's UNE pricing methodology and more economically rational UNE prices.

The number of such issues requiring Commission direction is not unduly large. Such issues, however, account for a large portion of the debate in UNE pricing cases. Clear Commission direction on these issues thus has the potential to provide tremendous assistance in the swift and orderly resolution of UNE pricing cases as well as ensuring consistent application of the Commission's TELRIC methodology. Specifically, the Commission should clarify how TELRIC models should handle depreciation, cost of capital, fill factors, non-recurring costs, and the assumption of a reconstructed network in calculating UNE prices. I explain these matters briefly below and in more detail in Attachment A to this letter.

Depreciation: While TELRIC purports to reflect the forward looking costs of a reconstructed network employing the most efficient technology, virtually all states applying TELRIC have applied historical, backward-looking legacy regulation depreciation rates devised years ago. These rates are inconsistent with real depreciation lives of real telephony assets in the ground, and they are even more inconsistent with the forward-looking TELRIC methodology itself, which assumes, after all, a hypothetical competitor that maintains state-of-the-art equipment. Indeed, legacy regulation depreciation rates are so far removed from reality that SBC must maintain separate books with separate depreciation schedules for regulatory and financial reporting purposes. The Commission should clarify that states should apply accurate and reasonable economic depreciation lives used for financial reporting purposes in TELRIC pricing models.

Cost of Capital: Six years ago, in the *Local Competition Order,* the Commission found that the current authorized rate of return (11.25%) "is a reasonable starting point for TELRIC calculations," while acknowledging that an increase in risk can increase the cost of capital. The industry today is in a state of crisis, with bankruptcies, falling revenues, massive debt, and gloomy analyst reports. In this environment, the cost of capital unquestionably is higher than it was six years ago. In fact, Moody's Investors Services recently placed the ratings of SBC and other Bell companies on review for a possible downgrade. In announcing this review, Moody's cited (1) weak revenue growth and declining access lines *due primarily to the UNE-P;* (2) competitive threats from

cable, wireless, and long distance operators; and (3) *an unfavorable regulatory pricing environment.* The fact that wholesale rates that reflect an unreasonably low cost of capital could themselves be responsible for a downgrade in our debt rating that will, in turn, likely increase the cost of capital is an irony that is troubling indeed. Moody's now maintains negative long-term ratings for SBC, Verizon, and BellSouth. Analysts as well have issued bearish reports on the Bell companies, often citing the downward spiral of UNE-P prices for their pessimism. Yet 9 of the 13 states in the SBC region have set TELRIC prices based on an assumed cost of capital that is *less* than the 11.25% starting point suggested by the Commission. In these nine states, the average cost of capital used for TELRIC purposes is only 10.08%. This rate is in stark contrast to the cost of capital SBC uses in cost proceedings, which is 12.19% (a market-based, industry average valuation). While SBC's cost of capital is not currently before the Commission, the Commission should make clear that the heightened risk in today's environment must be taken into account in establishing a cost of capital for use in any TELRIC proceeding.

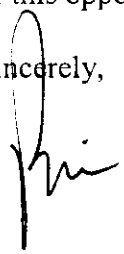
Fill Factors: Today's network fill factors reflect the incentives each carrier has to reduce costs in a competitive environment, while providing sufficient capacity to meet demand and comply with regulatory requirements. There is thus no reason to believe that a hypothetical, most-efficient network will achieve fill rates any different than actual observable fill rates. Nevertheless, UNE rates in a number of states are based on distribution fill factors as high as 80 and even 90%. These rates, not only are well in excess of existing levels, they are beyond the reach of a "hypothetical optimally efficient competitor." In the real world, no carrier can achieve such high distribution fill rates. The Commission should clarify that, since the implementation of price caps, LECs have had every reason to optimize their fill rates, and that actual fill rates in today's networks should be used as TELRIC inputs. That would be a conservative approach, given that growing intermodal competition is likely to reduce, not increase, fill rates. Simply put, as intermodal competitors (e.g. wireless, cable telephony and VOIP) continue to add customers, fill factors for incumbent local exchange carriers will decline as they lose access lines.

Network Evolution: In applying TELRIC, a number of states assume that, as more efficient technology and equipment becomes available, that technology and equipment will instantaneously and universally displace existing networks. They also assume that all network equipment will be deployed immediately to serve all demand over the life of the network. These assumptions are inconsistent with the reality that networks evolve over time, both in terms of technology and equipment. They are also inconsistent with the excessively long depreciation rates states typically use in applying TELRIC. The Commission has already acknowledged that UNE prices "may reasonably take into account that there will be growth in that network in the future, and that it may not be cost-effective to acquire all of the projected need at the outset." *GA/LA 271 Order* at ¶ 82. The Commission should now go further and make clear that UNE prices *must* take into account the fact that even the most efficient real companies in the real world do not replace their networks overnight with new technology and equipment but, rather, do so over time, and that it is inefficient to do otherwise.

Non-recurring costs: Some states have misapplied TELRIC by assuming that non-recurring costs should be based on a hypothetical network in which all processes are automated and virtually no manual labor is required. But non-recurring costs reflect activities that are directly observable and measurable and that must be performed on actual networks to provision actual facilities. The Commission has already recognized this principle by ruling that incumbent LECs are entitled to recover loop-conditioning costs and by rejecting CLEC arguments that there would be need for loop conditioning in a reconstructed local network using the most efficient technology. That same reasoning applies to other manual processes as well. The Commission must make that clear. It should clarify, in particular, that non-recurring charges for all UNEs should be based on the activity reasonably required to provision each UNE.

Clarification in each of these areas is critical to a more sustainable and efficient wholesale pricing methodology. There is no time to lose. The lack of specific direction with respect to these matters is resulting in a completely irrational stampede toward ever-lower UNE prices. These rate reductions promote more widespread use of the UNE-P, but that kind of artificial competition does not create a foundation for long-term health of the telecommunications and high tech manufacturing sectors, for sustainable competition, or for capital investment. To the contrary, it is a sure recipe for a continued downward spiral of the entire industry. A vehicle for corrective action is available. Pricing decisions will soon be rendered in the Virginia arbitration. I urge you to take advantage of this opportunity to begin the process of restoring economic health to our industry.

Sincerely,



Attachment

CC: Commissioner Abernathy
Commissioner Copps
Commissioner Martin
Mr. William Maher-Chief Wireline Competition Bureau

The Commission's UNE pricing rules are largely a high level description of the Commission's TELRIC methodology and contain no specific guidance as to the critical inputs or cost model assumptions to be used in actually calculating UNE prices. Additional, more detailed guidance is necessary at this time on a select group of cost model inputs and assumptions. Such guidance is imperative in order to promote efficient, economically rational UNE prices, and to encourage continued telecommunications investment.

The Commission's TELRIC pricing methodology is intended to simulate UNE prices that would be found in a perfectly competitive market. Estimating such prices is a difficult task under any circumstances, but it is nearly impossible if the inputs used in TELRIC cost models are inappropriate or inaccurate because the TELRIC methodology and the Commission's UNE pricing rules are unclear and subject to inconsistent interpretations. The wide variance in UNE prices among the states amply demonstrates the inconsistent application—and misapplication—of the Commission's TELRIC methodology and the need for the Commission to provide additional guidance to prevent further misinterpretations. *Compare, e.g.*, Commerce Capital Markets' calculated average Illinois, Indiana, and Michigan UNE-P prices of $15.96, $16.87, and $14.50 with its calculated average Georgia and Florida UNE-P prices of $23.83 and $26.18.[1] The Commission promised in 1996 to review its TELRIC methodology and provide guidance. The Commission must now fulfill that promise in order to ensure consistent and economically rational application of its TELRIC methodology and resulting UNE prices.[2]

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[1] Commerce Capital Markets, *The Status of 271 and the UNE-Platform in the Regional Bells' Territories* (August 22, 2002).

[2] The Commission has reviewed UNE prices in its orders approving various Section 271 applications. Its purpose in doing so, however, has not been to provide specific direction as to TELRIC inputs or model assumptions, but rather to determine whether a BOC's state UNE rates are checklist compliant. Indeed, the Commission has said that it will reject UNE prices in a Section 271 application only if those prices reflect violations of "basic" TELRIC principles or are based on factual errors so substantial that the resulting UNE prices fall outside the range produced by a reasonable application of TELRIC

UNE pricing disputes generally focus on a handful of critical cost model inputs and assumptions that impact directly and substantially the prices generated by UNE cost models. These inputs and assumptions include depreciation rates, cost of capital, fill factors, the assumption of an instantaneous reconstructed network, and assumptions concerning the calculation of non-recurring costs. Commission guidance on these core inputs and assumptions is needed to ensure consistent and appropriate application of the Commission's TELRIC methodology.[3]

In providing such guidance, the Commission would in no way "usurp the role" of state commissions in setting UNE prices as suggested by Z-Tel in its July 29th letter on this subject. Direction on a select group of core input and cost model assumption issues will ensure proper application of the Commission's UNE pricing methodology by state commissions and produce economically rational UNE prices. Moreover, contrary to Z-Tel's assertion, Commission direction on a core set of issues *will* provide certainty, because it will substantially reduce and hopefully eliminate the inconsistent application of the Commission's methodology in calculating UNE prices.

DEPRECIATION

The Commission's UNE pricing rules require the use of "economic depreciation rates" in the calculation of UNE prices. 47 C.F.R. § 51.505(b)(2). In addition, the Commission defined the general scope of "embedded costs" incompatible with its TELRIC methodology to include costs that "incumbent LECs carry on their accounting books that reflect historical purchasing prices, ***regulatory depreciation rates***, system

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principles. *New York 271 Order* ¶ 244. The Commission has thus found that a TELRIC input rejected elsewhere might be reasonable under the specific circumstances of a Section 271 application. *New Jersey 271 Order* ¶ 17. The UNE prices reflected in the Commission's Section 271 Orders are thus symptomatic of the inconsistent interpretation and application of the Commission's TELRIC methodology and provide further illustration of the need for the Commission to issue specific guidance as to the application of its TELRIC methodology.

[3] The Commission thus need not be concerned about the parade of horribles of an "input-by-input" analysis as suggested by AT&T in its July 26th letter on this subject.

configurations, and operating procedures." *Local Competition Order* ¶ 632 (emphasis added). The Commission has provided no other guidance, however, as to how economic depreciation rates should be determined or how they should be used to calculate UNE prices.

Consistent with the Commission's prohibition against using costs based on backward looking legacy regulation depreciation rates, SBC has proposed the economic depreciation lives it uses for financial reporting purposes as inputs to its recommended UNE cost models. Nonetheless, most states in SBC's territory (*e.g.*, Connecticut, Illinois, Kansas, Indiana, Michigan, Missouri, Ohio, Texas, and Wisconsin) have adopted federal or state legacy regulation depreciation rates in setting UNE prices, rather than depreciation rates established pursuant to generally accepted accounting principles and used by SBC for financial reporting purposes. As an example, UNE rates in Connecticut are based on state-prescribed legacy regulation depreciation lives that were established in Connecticut in 1995, before the Act was passed. Most recently, Missouri and Wisconsin set UNE prices using legacy regulation depreciation lives, with little justification for using such lives rather than the lives SBC uses for financial reporting purposes.

Such legacy regulation depreciation rates are wholly incompatible with the Commission's forward-looking TELRIC methodology. Legacy regulation depreciation rates often were established before the Act was passed and are based on long depreciation lives that were specifically designed to achieve regulatory ratemaking objectives. In contrast, the Commission's least-cost, most efficient network technology assumptions assume a level of rapid technological obsolescence—and, therefore, shorter depreciation lives—that is fundamentally incompatible with the longer lives of legacy regulation depreciation rates. As an example of the magnitude of the difference between legacy regulation depreciation lives and economic depreciation lives, SBC's economic depreciation lives for switching equipment are almost half the length of the legacy regulation depreciation lives for the same equipment.

Economic depreciation rates more closely reflect the efficiency assumptions that are at the heart of the Commission's UNE pricing methodology.[4] They are more consistent with the overall approach of requiring that UNE price models reflect the deployment of the most up-to-date technologies. The Commission, therefore, should clarify that it is inappropriate to use backward looking legacy regulation depreciation lives in the calculation of forward looking UNE prices.[5]

COST OF CAPITAL

Another critical issue is the appropriate cost of capital to be used to calculate UNE prices. The Commission's rules say only that the "forward looking cost of capital shall be used in calculating" the TELRIC of an element. 47 C.F.R. § 51.505(b)(2). In its *Local Competition Order*, the Commission added some additional guidance, by agreeing that "as a matter of theory, an increase in risk due to entry into the market for local exchange service can increase a LEC's cost of capital." *Local Competition Order* ¶ 687. The Commission also concluded that the then current authorized rate of return (11.25%)

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[4] In its *KS/OK 271 Order*, the Commission found that depreciation lives used for financial reporting purposes "are not necessarily unreasonable." *KS/OK 271 Order* ¶ 76. The Commission also said, however, that it would be reasonable to use the depreciation rates set by the Commission for regulating interstate services. *Id.* The Commission should eliminate this discrepancy. There is no principled basis to allow states to choose depreciation rates that serve fundamentally different purposes. The basic principles of the Commission's TELRIC methodology—the assumption of least cost, forward-looking technology deployment—should be applied consistently across the country. Such consistent application should include the determination of the appropriate depreciation rates to be used in calculating UNE prices. The determination of this critical component of the Commission's TELRIC methodology is not an input that varies from state to state, and allowing states to inconsistently interpret and apply such a basic component of the Commission's TELRIC methodology results in an incoherent national UNE pricing regime.

[5] AT&T's suggestion that incumbents could ask the Commission to institute new three-way proceedings to establish new regulatory depreciation rates misses the boat entirely. The Commission's UNE pricing rules require the use of economic depreciation lives. Regulatory deprecation lives serve different purposes than economic depreciation lives, and instituting new three-way proceedings to establish new legacy regulation depreciation rates will not produce more appropriate depreciation inputs for UNE price models than economic depreciation rates used by ILECs for financial reporting purposes.

"is a reasonable starting point for TELRIC calculations, and that incumbent LECs bear the burden of demonstrating with specificity that the business risks that they face in providing unbundled network elements and interconnection services would justify a different risk-allocated cost of capital or depreciation rate." *Local Competition Order* ¶ 702; *see also Verizon* slip op. at 48 ("The order thus treated then-current capital costs and rates of depreciation as mere starting points, to be adjusted upward if the incumbents demonstrate the need.") This limited additional clarification has been insufficient to prevent inappropriate cost of capital inputs from being used in the calculation of UNE prices.

Given the changes in the market and the economy since 1996, the appropriate cost of capital for calculating UNE prices should be higher than the 11.25% that the Commission adopted—at the genesis of the Act, in the absence of significant competition—as the *starting point* for cost of capital calculations. Despite AT&T's casual dismissal of the increased threat of competition in its July 20th letter, the *UNE Fact Report* submitted by SBC and others in the Commission's *Triennial Review* proceeding demonstrates that ILECs face substantial and increasing competitive risks. Such risks compel use of a higher cost of capital for calculating UNE prices.

There is far more volatility in the telecommunications sector in general and for the RBOCs in particular than predicted at the time of the *Local Competition Order*. Objective evidence of this volatility abounds. From March 2000 to July 2002, the telecommunications sector alone accounted for 40% of the total loss in market value of publicly traded U.S. companies. In total, $2 trillion of market capitalization has been lost. This slump has affected every sector of the industry, including the RBOCs, which lost 40% of their market value in just the last year. Nor is there a light at the end of the tunnel. As wireline carriers struggle with massive debt, declining revenues, and, for the first time in modern history, access line *losses*, the outlook for the industry is challenging, to say the least. These challenges have not been lost on analysts and credit rating

agencies, whose assessments have a significant impact on carriers' cost of capital. An increasing number of analysts are bearish on the RBOCs, and Moody's investment services now maintains a negative rating on all them. Indeed, Moody's just placed the long term debt ratings of SBC on review for possible downgrade. In doing so, it specifically noted that the business risk profile for RBOCs is increasing due to, *inter alia*, competitive threats from cable, wireless, and long distance operators.

As a result of this risk, it is harder for the entire telecom sector, including RBOCs, to obtain capital, and the ratio of equity to debt is far higher now than at the time of the Act. Such increases in volatility and scarcity of working capital more than offsets any decrease in the cost of borrowing resulting from generally lower interest rates. The cost of capital used to calculate UNE prices must account for this risk and volatility.[6]

SBC has calculated that its current cost of capital for determining UNE costs is 12.19%. Nonetheless, 9 of the 13 states in SBC's territory have rates based on cost of capital values not only less than 12.19%, but less—often significantly less—than the 11.25% starting point established by the Commission. The cost of capital in those 9 states averages only 10.08%, and varies from a low of 9.52% in Illinois to no more than 10.6% in Michigan. Such values are incompatible with the volatile nature of today's marketplace and the tenets of the Commission's forward-looking economic cost-based methodology.

The Commission should revise its starting point for cost of capital to reflect the additional risk in the marketplace since 1996. The Commission also should reinforce that the cost of capital inputs in UNE pricing models should reflect the business risks associated with today's greater competitive landscape.

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[6] Moreover, uncollectibles is not a "makeweight" as suggested by AT&T. SBC faces losses of hundreds of millions of dollars in pre-bankruptcy debt during just the last two years. Indeed, SBC's wholesale uncollectibles grew nearly 400% from 2000 to 2002. The risk of wholesale uncollectibles is thus significant and must be accounted for in the cost of capital used to calculate UNE prices.

FILL FACTORS

A third critical issue concerns the appropriate fill factors to be used to calculate UNE prices. The Commission's rules provide little direction as to appropriate fill factors for use in calculating UNE prices. The *Local Competition Order* says only that "reasonably accurate" fill factors should be used. *Local Competition and Order* ¶ 682. The Commission should provide additional guidance on the appropriate fill factors to be used in calculating UNE prices.

Since the adoption of price caps in 1991, ILECs have had strong incentives to achieve as efficient network fill rates as possible. Indeed, the growing financial pressures to which the ILECs are subject have only heightened their incentives to increase efficiency in any way possible, including by maximizing fill rates consistent with the need to provide sufficient capacity to meet demand and comply with regulatory requirements such as carrier of last resort obligations. No amount of forward-looking technological network change will alter those fundamental incentives and obligations.

Current network fill rates are thus the best estimates of forward-looking fill rates for use in UNE pricing models.[7] Nonetheless, CLECs have vehemently insisted that the Commission's general prohibition against embedded costs precludes consideration of network fill rates in calculating UNE prices. Thus, they have persuaded some states to adopt unreasonably high fill factors that bear little or no relationship to real world projections of capacity and fill. High fill factors significantly lower UNE loop prices.

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[7] In its *KS/OK 271 Order*, the Commission was concerned that actual fill had been used for determining the cost of transport and distribution facilities without considering whether "actual fill factors were those of an efficient provider." *KS/OK 271 Order* ¶ 79. The Commission, however, did not *per se* reject the use of actual fill factors. Rather, its concern was limited to the support provided for using actual fill factors in that case. As discussed above, a review of the conditions under which the ILECs have been operating their networks over the past decade or more amply demonstrates and supports the conclusion that actual fill factors are, in fact, those of efficient providers and are thus fully consistent with the Commission's TELRIC methodology. At a minimum, it supports a presumption that actual fill rates should be used to calculate UNE prices.

UNE rates in some states (*e.g.*, Ohio) are based on distribution fill factors as high as 80 or even 90%. No carrier achieves distribution fill factors that high, and not even a hypothetical most efficient, forward-looking network could achieve distribution fill factors that high.

Another recent example is Wisconsin, which adopted a 70% distribution fill factor, representing "optimal" distribution fill, solely on the basis that Ameritech's proposed fill factors would cause an unreasonable increase in cost. In other words, a 70% distribution fill factor was adopted not because it represented a reasonable estimate of distribution fill in a forward-looking least cost network, but simply because it produced lower UNE rates. Similarly, Missouri recently used a 90% fiber fill factor in setting UNE prices. Increasing cost study fill rates beyond the actual real world network fill factors is simply an outcome-oriented tool for decreasing UNE loop prices. Moreover, it is inconsistent with the lone additional guidance that the Commission provided on this issue in the *Local Competition Order* that cost studies should reflect "a reasonable projection of the *actual total usage* of the element." *Local Competition Order* ¶ 682 (emphasis added). To prevent such misapplications of the Commission's TELRIC methodology, the Commission should clarify that forward-looking projections of fill should be based on current network fill rates.

THE RECONSTRUCTED NETWORK ASSUMPTION

A fourth critical issue is the appropriate assumptions concerning network deployment and the evolution of networks over time. The Commission's UNE pricing methodology requires a long run perspective and "use of the most efficient telecommunications technology currently available." 47 C.F.R.§ 51.505(b)(1). In the *Local Competition Order*, the Commission clarified that long run "refers to a period long enough so that all of a firm's costs become variable or avoidable." *Local Competition Order* ¶ 677. It also made clear that its "forward-looking" requirement was designed to produce UNE prices based on "efficient, new technology that is compatible with the existing infrastructure." *Local Competition Order* ¶ 685. The Commission provided no additional direction, however, as to how UNE cost models should account for the evolution of telecommunications networks and the integration of new technology and additional equipment over time to serve reasonably foreseeable demand.

The CLECs have used this gap in the Commission's description of how to apply its "reconstructed" network requirement to advocate cost models that assume instantaneous and universal replacement of all technology and equipment in an incumbent's network. This approach is inconsistent with the reality that networks evolve over time, both in terms of technology and equipment. Indeed, the Commission has agreed that UNE prices "may reasonably take into account that there will be growth in that network in the future, and that it may not be cost-effective to acquire all of the projected need at the outset." *GA/LA 271 Order* ¶ *82*. Thus, even in a forward-looking approach, it is appropriate to consider that networks will grow and incorporate new technology over time, rather than instantaneously.

Moreover, the assumption of a flash cut, instantaneous network deployment and equipment replacement is incompatible with most depreciation rates used as inputs in TELRIC pricing models. As discussed above, legacy regulation depreciation lives are exceedingly long. If network evolution is not reflected in the technology and equipment

assumptions in a UNE cost model—*i.e.*, if a model assumes instantaneous replacement as more efficient, least cost, equipment becomes available—the depreciation lives used to calculate UNE prices must be much shorter than legacy regulation depreciation lives. That, however, is rarely the case in UNE rate cases, in which legacy regulation depreciation lives are most often used in conjunction with the incompatible assumption of instantaneous technology and equipment deployment.

AT&T's argument against basing UNE prices on "the costs of the incumbents' existing, embedded networks, with forward-looking adjustments limited to those that the incumbents expect to make in some arbitrary short-run period" is no more than a strawman response to this issue. The real focus of this issue is the recognition that networks evolve over time, and that no network, not even a forward-looking one, will ever reflect instantaneous deployment of 100% any particular type of equipment or technology. SBC is thus not requesting that the Commission "jettison" its long run cost standard. Rather, it requests that the Commission clarify that an evolutionary approach to network deployment is fully consistent with a long run standard.

The impact of this issue can be illustrated with reference to switching costs. To serve forward-looking demand, incumbents will, over time, purchase a combination of replacement and growth switches. It is, therefore, appropriate in a forward-looking model to reflect a reasonable combination of replacement and growth switch deployment—with respective switch vendor discounts for new and growth switches—in a manner that reflects the true forward-looking cost of switches. This is critical, because switch vendors often provide steep discounts for replacement switches, but much smaller discounts for growth equipment. Thus, assuming that all or most switch deployment consists of lower cost replacement switches and associated replacement switch vendor discounts, produces much lower estimated switch costs and lower switch prices than any carrier could ever achieve.

Nonetheless, some states, including virtually all of the Ameritech states, have adopted UNE prices based on untenable assumptions regarding deployment of new and growth switch deployment. Such states have done so primarily by applying replacement prices to most or all of the embedded base of SBC switches, rather than applying replacement and growth prices to a forward-looking mix of switch purchases.

The deployment of IDLC is another example. Because all networks will, at any given time, reflect a mix of old and new technology, no network will ever reflect 100% deployment of any given IDLC technology, assuming that IDLC is a more efficient, forward-looking technology. Rather, at any given time, any network will reflect a mix of IDLC and older technologies, and even newer technologies that become available and displace IDLC. Certain states, however, have adopted UNE prices based on the assumption of 100% IDLC deployment. In Michigan, for example, UNE loop rates were set based on an assumption of 100% IDLC deployment, even though no network will ever consist of 100% IDLC. In order to prevent such future errors, the Commission should clarify that its forward-looking methodology recognizes that networks evolve over time and reflect a reasonable mix of old and new and replacement and growth technology and equipment.

NON-RECURRING COSTS

Finally, the Commission should clarify that incumbents are entitled to recover the non-recurring costs they must reasonably incur in provisioning UNEs. Some CLECs have used the Commission's forward-looking, reconstructed network requirement to argue that non-recurring rates should be based on a hypothetical network in which all processes are automated and virtually no manual labor is required. For example, Indiana established a $0.41 charge for new UNE combinations. The work actually performed by SBC circuit provisioning and maintenance groups for new UNE combinations costs much more than $0.41. Nonetheless, the Indiana commission eliminated such costs in calculating the non-recurring charge for new combinations.

Non-recurring rates should reflect activity that is directly observable and measurable, and which must be performed on real networks to provision real facilities ordered by CLECs. With respect to loop conditioning charges, the Commission has made clear that incumbents are entitled under the Commission's UNE methodology to recover their actual costs of performing the non-recurring activity associated with conditioning a loop.[8] There is no logical distinction in allowing incumbents to recover non-recurring loop conditioning charges and allowing incumbents to recover the reasonable costs of performing other non-recurring activities required to provision UNEs. Accordingly, the Commission should clarify that non-recurring charges for all UNEs should be based on the activity reasonably required to provision each UNE.

Additional guidance from the Commission is necessary to clarify how those rules should be applied in practice in calculating UNE prices. Failure to do will so will facilitate the continuing downward spiral of economically irrational UNE prices. Additional guidance will help ensure the fulfillment of the Commission's objective of continued facilities-based competition. SBC urges the Commission to issue such guidance expeditiously and through any and all vehicles available to it.

[8] In its Section 271 orders, the Commission also approved non-recurring UNE rates that reflect the actual work required to provision UNEs. *See, e.g., New Jersey 271 Order* ¶ 64 (AT&T failed to present persuasive evidence that the New Jersey Board committed clear error in rejecting AT&T's non-recurring cost model, which "assumed away" certain non-recurring work activities due to "mechanized improvements.")

CERTIFICATE OF SERVICE

I, Myra D. Creeks, hereby certify that the foregoing Ex Parte presentation has been filed this 6th day of September 6, 2002 to the Parties attached.

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